

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM  
STATEMENT OF INVESTMENT POLICY**

**FOR  
DIRECTED BROKERAGE ARRANGEMENT**

**November 13, 2007**

*This policy is effective immediately upon adoption and supersedes all previous Directed Brokerage policies.*

**I. PURPOSE**

The CalPERS Total Fund Statement of Investment Policy, adopted by the CalPERS Investment Committee ("Committee"), sets forth CalPERS' overarching investment purposes and objectives with respect to all its investment programs.

This document sets forth the investment policy ("Policy") for Directed Brokerage Arrangement ("Arrangements"). The design of this Policy ensures that internal and external investment managers or other participants selected by the California Public Employees' Retirement System ("CalPERS") take prudent and careful action while participating in the Arrangements. Additionally, use of this Policy provides assurance that there is sufficient flexibility to obtain goods and services necessary for the prudent management of the fund while adhering to all regulatory standards.

**II. POLICY OBJECTIVE**

Arrangements shall be managed to maximize the funds available for investment research, analysis, analytical tools and transaction services by implementing industry accepted practices related to the recapture of commissions paid by CalPERS to [brokers](#). CalPERS' [investment managers](#) and associated brokers shall not compromise their duties to seek [best execution](#) in implementing these Arrangements.

**III. RESPONSIBILITIES**

- A. CalPERS' Fiscal Services Staff ("Fiscal Staff") is responsible for the following:
  - 1. Monitoring the implementation of, and compliance with, the Policy. Staff shall report concerns, problems, material changes, and all violations of the Policy immediately and in writing to the Committee. These reports shall include explanations of the violations and appropriate recommendations for corrective action;

2. Monitoring and reconciling commissions recaptured, and resolving variances between managers and brokers monthly;
  3. Accounting for all funds generated from the Arrangements;
  4. Preparing monthly external manager reports on commissions earned; and,
  5. Maintaining records and reports of recaptured commissions.
- B. CalPERS' Investment Office Staff ("Staff") is responsible for the following:
1. Contracting with external investment managers who will be required to direct a portion of their normal trading activity to brokers participating in CalPERS' Arrangements, if in CalPERS' best interest. Staff shall include directed brokerage language in the external investment manager contracts and negotiate with each manager the terms of their participation in the Arrangements;
  2. Adhering to the Policy as it applies to internally managed portfolios.
  3. Evaluating and recommending the addition or removal of brokers from the Arrangements:
    - a. Additions - CalPERS shall authorize the use of brokerage firms that have expressed an interest in participating and that are deemed to add value and choice to CalPERS' available brokerage firms. The brokerage firms must be capable of providing trade transactions on a "best execution" basis. Brokers shall be added pursuant to a written agreement between CalPERS and the brokerage firm initiated and approved by Staff.
    - b. Removals – Removal from the Arrangements shall be based upon the Staff's evaluation and recommendation, including, but not limited to:
      - i. The level of commissions generated; and,
      - ii. Relative ranking compared to other participating brokers.
  4. Adhering to all of CalPERS' standard procurement procedures when making purchases with recaptured commissions. In addition, CalPERS' procedures require Senior Investment Officers to attest

to Securities and Exchange Commission (SEC) Section 28 (e) eligibility.

5. Reviewing the activities of CalPERS' external investment managers that are participating in the Arrangements to validate that:
  - a. A portion of their normal trading activity is being directed to a participating broker who is returning a percentage of its commission to CalPERS; and,
  - b. The investment manager is using best efforts to obtain best execution for securities traded for CalPERS.

#### IV. ARRANGEMENT PARAMETERS

- A. Arrangements:** Arrangements involve trading by internal or external investment managers which is executed through a specific broker (or a list of participating brokers) for the benefit of CalPERS. In exchange for directing, or having its investment managers direct, trades to a specific broker, CalPERS receives a benefit (recaptured commissions) in addition to execution services. Other forms of arrangements exist, however CalPERS only utilizes this type of recapture Arrangement.

Commission recapture is an arrangement whereby staff and those investment managers hired by CalPERS that have an investment strategy conducive to, and a willingness to participate in the Arrangement, direct trades to CalPERS' list of participating brokers. The broker then returns a portion of its commission to CalPERS. Under this Arrangement, the broker does not directly pay CalPERS' obligations nor does CalPERS direct the external investment manager to use a specific broker. In addition, CalPERS does not pay a higher commission rate than the external investment manager's other clients as a result of the Arrangements.

- B. Use of Funds:** One of three criteria must be met for recaptured commissions to receive the protection afforded by Section 28(e) of the Securities Exchange Act of 1934. The services acquired from its Arrangements must adhere to these criteria. Services must be "brokerage and research" services, defined as follows:

1. Furnishing advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in purchasing or selling securities, and the availability of securities or purchasers or sellers of securities;

2. Furnishing analyses and reports concerning issues, industries, securities, economic factors and trends, portfolio strategy and the performance of accounts; or
3. Effecting securities transactions and performing functions incidental thereto such as clearance, settlement and custody, or required in connection therewith by rules of the SEC or a self-regulatory organization of which such a person is a member or person associated with a member or in which such a person is a participant.

Services not protected by the provisions of Section 28(e) include computer hardware, professional licensing fees and general office overhead expenses. Therefore, they cannot be purchased using commissions recaptured as part of CalPERS' Arrangements.

## **V. ARRANGEMENT IMPLEMENTATION**

CalPERS recognizes that the generation of commissions is inherent in the trade execution function of the investment process. Arrangements are a widespread industry practice to recover, recapture and use a portion of commissions generated by normal trade activity to defray expenses associated with portfolio management.

### **A. Commission Recapture**

The participating brokers will transfer the recaptured commission to CalPERS in accordance with their agreement with the investment manager. These funds shall be deposited into the Public Employee's Retirement Fund (PERF) in a portfolio maintained by the master custodian. The recaptured commissions received will be tracked by Fiscal Services staff and reported to the Finance Committee.

### **B. External Participants**

#### **1. Determining External Manager Participation**

The Investment Staff shall determine which external investment managers will participate in the Arrangements. The managers shall be selected in accordance with the Board's Contract and Procurement Policies. Factors included in determining the most qualified investment managers are as follows:

##### **a. Best Execution**

The ability of a manager to achieve best execution shall be the most important factor in the Investment Staff's analysis. The costs associated with executing a trade are both implicit and

explicit. The explicit cost is the commission cost associated with administering the trade (brokerage charge, stamp-tax, SEC charge, etc). Implicit costs are market impact costs and opportunity costs.

b. Manager's Investment Strategy

A manager's investment strategy may or may not lend itself to the Arrangements without jeopardizing best execution. For example, active equity and enhanced index managers as well as those that execute a large number of program or principal trades are not generally good candidates for participation in the Arrangements due to their trading strategies. Also, managers that trade certain types of securities such as small cap securities, emerging markets securities, thinly traded securities or trades on less liquid international exchanges generally do not participate in the Arrangements.

Managers with value and growth strategies are more deliberate in their trading and are more price sensitive in their buy and sell decisions. Both of these general practices make them good candidates for participation in the Arrangements.

The list of CalPERS' participating brokers should be sufficient to provide the majority of external investment managers the ability to identify a number of brokers to utilize.

c. Manager's Level of Participation in Other Clients' Directed Commission Programs

Investment managers must participate in Arrangements for other clients. A manager's trading style and process can be influenced by participation in Arrangements for its client base. CalPERS shall not require a manager to direct trades for its portfolio(s) if the manager does not already do so for other clients. Overall execution may be compromised if the manager is required to process CalPERS' trades differently.

2. Managers - Reporting

CalPERS' external investment managers shall be required to submit a monthly report to CalPERS' Fiscal Services Division and Investment Office no later than the 15<sup>th</sup> of the following month. This report shall be for all activity in the previous calendar month, for directed brokerage commissions and all other commissions.

Managers shall pre-reconcile with brokers prior to reporting to CalPERS.

3. Brokers - Reporting

CalPERS' participating brokers shall submit a monthly report to CalPERS' Fiscal Services Division and the Investment Office no later than the 15<sup>th</sup> of the following month. This report shall be for all activity in the previous calendar month, for commissions recaptured and all other commissions. Brokers shall pre-reconcile with investment managers prior to reporting to CalPERS.

4. Broker Termination

CalPERS' written agreements with its participating brokers shall provide that they may be terminated at any time, by either party, upon written notice, for any reason. Upon receipt of a termination notice, the broker shall promptly discontinue all services affected unless the notice specifies otherwise.

All duties and obligations of CalPERS and the broker shall cease upon termination of the written agreement between them, with the exception that each party shall remain liable for any rights, obligations, or liabilities arising from activities carried on by it under the agreement prior to the effective date of termination. Brokers will be required to remit any balance due to CalPERS within thirty (30) calendar days following termination.

## VI. GLOSSARY OF TERMS

Key words used in the policy are defined in CalPERS' Master Glossary of Terms.

Approved by the Policy Subcommittee:	December 14, 2001
Adopted by the Investment Committee:	February 19, 2002
Revised by the Policy Subcommittee:	June 16, 2006
Approved by the Investment Committee:	August 14, 2006
Revised by the Policy Subcommittee:	October 12, 2007
Approved by the Investment Committee:	November 13, 2007